

TEACHERS' RETIREMENT BOARD
BUDGETS AND AUDITS COMMITTEE

SUBJECT: Internal Audits Final Report – Soft Dollars

ITEM NUMBER: 10

ATTACHMENTS:

ACTION:

DATE OF MEETING: November 7, 2002

INFORMATION: X

PRESENTER: Way Lee

EXECUTIVE SUMMARY

We completed our audit of the California State Teachers' Retirement System's (CalSTRS) Soft Dollar (SD) Program, which was established in 1985 and is administered by the Investments Branch. The SD Program allows CalSTRS to use a portion of commissions, generated by CalSTRS' external managers; to defray investment-related expenses that otherwise would have been incurred and paid for using CalSTRS' operational budgeted funds. CalSTRS' SD Program includes a Client Directed Brokerage Arrangement (Directed Brokerage) as well as a typical manager directed Soft Dollar Arrangement (Manager Directed).

We conducted a comprehensive review of the SD Program and analyzed the overall internal control system. In doing so, we reviewed CalSTRS' policies and obtained information from the U.S. Department of Labor, Securities and Exchange Commission (SEC), Government Finance Officers Association, Financial Accounting Standards Board, Association for Investment Management and Research, and other public pension systems. We performed tests of the Directed Brokerage budgeting, invoice payment, and reconciliation processes, and overall SD Program monitoring processes. We also reviewed CalSTRS' broker and manager file records. We did not interview brokers or managers, nor did we document their internal control systems or analyze their trades for 'best execution'.

Based on the results of our initial audit fieldwork, which we completed in May 2001, we identified some significant weaknesses in the internal control system over the Directed Brokerage program. We discussed our observations and recommendations with management, and they requested time to access our review results. When we issued our final report in June 2002, management indicated that they had implemented many of our recommendations and made significant improvements to the internal control system. Consequently, we agreed to perform a follow-up review to assess the current status of practices and processes in some of the key control areas. Based on the results on our follow-up fieldwork, which we completed in October, 2002, we found that significant improvements had been made to the Directed Brokerage program. Management had implemented some of our recommendations and had taken additional steps to ensure that there are adequate controls over key areas of the program.

RECOMMENDATIONS FOR IMPROVEMENT:

During our initial review, we identified areas where the internal control system could be strengthened to further mitigate risk exposure. We documented our observations and developed recommendations for corrective action and/or improvements. As indicated above, we performed a follow-up review to verify managements' action taken to improve controls in key areas. In the first section below, we have identified our original recommendations and actions that we verified were taken by management, to strengthen controls in those key areas. In the second section, we have identified our recommendations and managements' response related to other control issues we initially reported on.

KEY CONTROL AREAS REVIEWED DURING FOLLOW-UP:

Recommendation - SD Budget Approval Process:

Management should implement a formal process to review the Directed Brokerage budget on a semi-annual basis, make necessary adjustments to account for additional approved expenditures and to delete canceled services, and report budget adjustments to the Board. Additionally, management should coordinate the reconciliation and budget monitoring to ensure that material commission credit funds available are used to purchase allowable goods and services or are rebated to CalSTRS, in a timely manner.

Actions taken by management to resolve issue: For the six months ended June 30, 2002, management developed a new dynamic, data tracking system for its Directed Brokerage program. The system tracks data from approved goods/services request forms and outputs a report that provides an Estimated versus Actual Expenses Summary. The semi-annual reports will be submitted to the Chief Investment Officer (CIO) on an on-going basis and will allow management to more effectively monitor the availability and use of commission credits.

Recommendation - Invoice Payment Process:

Management should assign staff to implement a tracking and reporting system to control and monitor Directed Brokerage expenditures. The tracking system should include information regarding the status of budgeted items, expenditure invoice details, timing of payments, and supervisory review and approval.

Actions taken by management to resolve issue: As indicated above, management has implemented a new data tracking and reporting system to control and monitor Directed Brokerage expenditures. The system tracks all data regarding payments made versus estimated expenses for each requested good/service and it assists staff in ensuring that Directed Brokerage expenditures are paid timely. The semi-annual report for the period ended June 30, 2002, was reviewed by the SD Manager and will be finalized and approved accordingly.

Recommendation - Reconciliation Process:

Management should ensure that the Investments Branch's records of CalSTRS' Directed Brokerage commission credits are regularly reconciled with the independent records of Directed Brokerage managers and brokers. Staff should report the results to management on a regular basis. As part of the reconciliation process, staff should ensure that managers meet their contractual obligations and reconcile their records to brokers' records prior to submitting monthly reports to CalSTRS. Brokers should comply with agreed-upon requirements for reporting all necessary monthly Directed Brokerage data.

Actions taken by management to resolve issue: Staff developed and implemented an automated template to standardize the monthly reporting and receipt of data from Directed Brokerage managers and brokers. Effective January 1, 2002, the managers and brokers submit all applicable data electronically to CalSTRS. This automated system allows managers and brokers to resolve their differences monthly so Investments Branch staff can then reconcile the transactions with CalSTRS' records. The data is also used to update the aforementioned budget-to-actual expenditure tracking system and to analyze year-to-date performance in achieving Directed Brokerage goals. The first semi-annual report was issued and reviewed by the SD Program manager and will be subsequently approved and forwarded to the CIO.

Recommendation - Segregation of Duties:

Management should ensure that there is an appropriate separation of duties over the record keeping, authorization, approval, and reconciliation functions for CalSTRS' Directed Brokerage program.

Actions taken by management to resolve issue: Additional staffing resources have been allocated to the Directed Brokerage program so that duties related to the reconciliation and budget processes are separated. Also, the SD Program manager is closely supervising all directed brokerage processes and regularly reviewing related reports.

Recommendation - SD Program Procedures: Staff should update and appropriately modify the Directed Brokerage procedures/processes described within the Soft Dollar (procedures) Manual. Staff should develop specific guidelines for processing invoices and reconciling records. Staff should also provide international managers and brokers with instructions regarding consistent use of the trade date (versus settlement date) to account for foreign exchange rate differences when calculating commissions.

Actions taken by management to resolve issue: Management has completed some desk procedures and is in the process of completing others regarding the budget, invoice payment, and reconciliation processes. Completed procedures are documented within the Directed Brokerage Desk Manual. Regarding foreign exchange transactions, both managers and brokers are now reporting commissions on a trade date basis within the aforementioned electronic reconciliation template.

MANAGEMENT’S RESPONSE TO OTHER ISSUES:

Recommendation - SD Program Policies:

Based on our research, it is our opinion that management should review and consider modifying its current Board approved policy for client directed brokerage commissions to further restrict the acceptable use of its commission credits to goods and services that are more closely related to investment decision-making activities. Specifically, we suggested that management define a list of acceptable goods and services that is more closely aligned to the criteria used by the SEC in its requirements for Manager Directed SD programs. We also recommended that management follow-through with its planned strategic objective to recapture CalSTRS’ unused Directed Brokerage commission credits from brokers or consider requiring that all commissions be rebated and used to directly reduce investment transaction costs. Furthermore, we recommended that management consider adding an additional reporting requirement to its SD Program policies regarding reporting of Directed Brokerage activities.

Management’s Response:

- ✓ *Management disagrees with the intent and spirit of our recommendation/opinion and feels that the current policy is appropriate. Management reiterated that the SEC restrictions apply to external investment managers and their use of client commissions and stated that since CalSTRS is the client under the Directed Brokerage program it can use the credits in any way that benefits the fund, including the recent remodel of the investment office.*
- ✓ *Management plans to continue its existing commission recapture program, which is in the form of commission credits rather than rebated checks. Management will explore other options regarding commission recapture; including surveying other plans similar to CalSTRS. Management does not believe that rebating checks directly to the fund mitigates the risk of collusion as well as the current commission credit program does. Having the managers and brokers involved represents a higher level of caution than a cash rebate system would have.*
- ✓ *Beginning with calendar year 2002, management will submit semi-annual reports to the CIO on the status of payments and balances.*

Recommendation - Monitoring of External Managers’ SD Programs: Management should regularly monitor its external managers’ SD programs. We recommended that external managers complete an annual questionnaire and submit it along with their certification (ADV) reports regarding their compliance with applicable SEC requirements. Staff should track the receipt and review of all required documentation. Staff could use checklists to ensure that SD and other issues are addressed during their on-site visits with external managers, as applicable. Additionally, staff should document their monitoring of external managers’ performance in achieving targeted SD goals. Finally, staff should review external managers’ files to ensure that applicable SD agreements are on file and that the Investments Branch’s listing of participating SD managers is current.

Management's Response:

- ✓ *Management does monitor the managers' SD programs but will formalize and document their monitoring efforts.*
- ✓ *Management does not agree that the investment managers should have the burden of work. Rather, Investments Branch staff will perform the monitoring along with the managers' ADV filings and the brokers' filing of quarterly, financial (FOCUS) reports.*
- ✓ *Management will formally document external managers' participation levels.*
- ✓ *The four agreements referred to have been sent out to the managers. Eighty-five percent of the agreements were on file.*

Recommendation - Monitoring of SD Brokers: Management should document its monitoring of SD brokers. Staff could use a checklist to ensure that SD issues are addressed during their on-site visits with third party brokers. Additionally, staff should track and review brokers' quarterly FOCUS reports to verify brokers' financial stability. Furthermore, for those brokers that are no longer involved with CalSTRS' Directed Brokerage program, staff should ensure that outstanding commission balances are liquidated and rebated to CalSTRS.

Management's Response:

- ✓ *Management has implemented a process to regularly communicate with third party brokers and will formally document all meetings including brokers' visits to CalSTRS' offices and when staff visit brokers' at their sites. The visits made to brokers in 2000 were well documented. However, 2001 visits were cut after 9/11/01.*
- ✓ *FOCUS filings are currently being tracked. Further, staff prepares a written report that tiers the brokers according to balance sheet status and presents it to the CIO on a semiannual basis.*
- ✓ *We now make a concerted effort to spend down all of the commission credit balances before taking a broker out of the program. Staff will work to get rebate checks from those brokers who decide to leave the program on their own.*